Vivekanand College, Kolhapur (Autonomous)

Department of Economics

Subject- Business Economics (Macro)

Topic- <u>Theories of Business Cycles</u>

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Theories of Business Cycles

Hawtrey's Theory of Business Cycle

Schumpeter's Theory of Business Cycle

Hawtrey's Theory of Business Cycle

- Its also called Hawtrey's Monetary Theory of Business Cycles
- His monetary theory relates to the economy which is under gold standard.
- It means money in circulation consists of gold coins or when paper notes are fully backed by gold reserves in the banking system.
- According to Hawtrey, increase in the quantity of money raises the availability of bank credit for investment.
- Expansion in money supply causes rate of interest fall.
- The lower rate of interest induces businessmen to borrow more for investment (capital goods or inventories).
- Higher output, income and employment caused by more investment induces more spending on consumer goods.

- Thus, as a result of more investment made possible by increased supply of bank credit economy moves into the expansion phase.
- The process of expansion continues for some time.
- Increase in demand leads to rise in prices.
- Rise in prices induces businessmen to more invest and more produced for getting high profit.
- Now according to Hawtrey this expansion phase must end.
- He argued that rise in income induces more expenditure on domestic as well as imported goods.
- For making payment of imported goods there will be outflow of gold standard.
- Since the country is on gold standard, outflow of gold will cause reduction in money supply in the economy.

- The decrease in money supply will reduce the availability of bank credit.
- Another side as banks go on increasing credit, their cash funds end and they are forced to stop or reduce credit and rise interest rates in order to discourage the demand for new loans.
- Also banks start to withdraw their money form market.
- These all reduce investment by Businessmen
- They do not demand for capital goods and inventory.
- So income and output start to reduce and as result demand for consumer goods will also fall.
- Due to less demand prices also fall.
- And this all lead to recession in economy.
- After some time period this recession phase also finish and again expansion phase will come.

Criticisms

- Regards business cycle as monetary phenomenon that is not true.
- Described only expansion and recession phases and fails to explain the intermediary phases of business cycles.
- Assumes that businessmen are more sensitive to the interest rates which is not full true. They think about future opportunities.

Still there are some criticisms, this theory try to explain that, how supply of money affect on business activities or economy.

Schumpeter's Theory of Business Cycle

- Joseph A. Schumpeter has given this theory.
- According to him, innovations as the originating cause of Trade Cycles.
- He has given difference between Inventions (discoveries) and Innovations (applications).
- So innovations cause cyclical fluctuations in economy.
- In broad sense such innovations may refer to changes the existing methods of production, or all of the following things.

1) The introduction a new product like a computer.

2) The introduction of a mechanical invention like tractors in agriculture.

3) The introduction of a new technique of production such as a laser printing.

4) New market for the existing products.

5) New sources of raw materials for producing old products.

6) New variety of raw materials at low cost.

- Innovation, however does not arise spontaneously. According to Schumpeter innovation introduced by an agent and agent is entrepreneur, so entrepreneurs are innovators.
- To carry out his innovative function, the entrepreneur needs two things.
- First he must have the technical knowledge to produce new products or new services. Second funds for production.
- The entrepreneur secures funds for his project not from savings out of his income but from the credit from bank system.
- Money capital and bank credit play a significant role in the Schumpeterian theory.

- Innovators/entrepreneurs start to collect resources for production which come from different industries.
- So due to more production of innovative goods causes more money income and prices also increase.
- This total situation gives good profit to innovator so he/she can invest more money for expansion of business.
- So when entrepreneur invest more and more production also increase.
- Results supply exceeds demand.
- This is expansion phase of business cycle.
- Now in secondary wave, impact of the original innovation on the competitors. It means competitors try copy original product and come to same track.

- The period of prosperity ends as soon as new product induced by the waves of innovations replace old ones.
- Low demand for old product so price goes down results producer firms forcefully contract their output. And recession phase starts.
- Another side innovators start to repay the credits. So velocity of money also less. Finally demand and prices fall.
- Society feels the depressionary situation.
- And according to Schumpeter, in this situation risk and uncertainty is high in economy.
- But innovation minded entrepreneurs continue their search for profitable innovations.

Criticisms-

1. His theory is highly institutional. (means only entrepreneurs are innovators and overemphasizes the role of the entrepreneur).
2. Schumpeter attributes trade cycles to the phenomenon of innovations only.
3. Schumpeter unrealistically assumes that innovations are financed solely by means of bank credit.